National Shawmut Bank, Boston

Foreign exchange of to-day

Boston

1920

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FOREIGN EXCHANGE

THE
NATIONAL SHAWMUT BANK
OF BOSTON

FOREIGN EXCHANGE OF TO-DAY

SHAWMUT SERIES No. 178
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1920

PARS OF EXCHANGE FOR GOLD STANDARD COUNTRIES

As Estimated by the U. S. Director of the Mint

	Country	Monetary Unit	Value in U. S. Dollars
AFRICA	Egypt	Egyptian Pound	$4.9431
	Liberia	Dollar	1.00
	British Colonies	Pound Sterling	4.8665
	French Colonies	Franc	.193
ASIA	India	Rupee	0.3244
	Japan	Yen	.4985
	Straits Settlements	Dollar	.5678
AUSTRALIA		Pound Sterling	4.8665
EUROPE	Austria	Krone	0.2026
	Bulgaria	Lev	.193
	Belgium	Franc	.193
	Czecho-Slovakia	Krone	.2026
	Denmark	Krone	.268
	Finland	Finmark	.193
	France	Franc	.193
	Germany	Mark	.2382
	Great Britain	Pound Sterling	4.8665
	Greece	Drachma	.193
	Italy	Lira	.193
	Kingdom of the Serbs, Croats and Slovenes	Dinar	.193
	Netherlands	Guilder (Florin)	.402
	Norway	Krone	.268
	Poland	Mark	.2382
	Portugal	Escudo	1.08
	Roumania	Leu	.193
	Russia	Rouble	.5146
	Spain	Peseta	.193
	Sweden	Krona	.268
	Switzerland	Franc	.193
	Turkey	Turkish Pound	4.40
NORTH AMERICA	Canada	Dollar	1.00
	Central America		
	Costa Rica	Colon	.4653
	British Honduras	Dollar	1.00
	Nicaragua	Cordoba	1.00
	Guatemala, Honduras, Salvador	Peso	.8078
	Panama	Dollar	1.00
	Mexico	Peso (Gold)	.4985
	Cuba	Dollar	1.00
SOUTH AMERICA	Argentina	Gold Peso	0.9648
	Bolivia	Boliviano	.3893
	Brazil	Milreis	.5462
	Chile	Gold Peso	.3650
	Colombia	Dollar	.9733
	Ecuador	Sucre	.4867
	Paraguay	Peso	.9648
	Peru	Libra	4.8665
	Uruguay	Peso	1.0342
	Venezuela	Bolivar	.193

FOREIGN EXCHANGE OF TO-DAY

Vital Importance of Foreign Exchange as a Factor in Foreign and Domestic Commerce—General Principles—Gold Pars and Shipping Points—Present Exchange with Europe Characterized by the Disappearance of the Lower Shipping Point—Illustrated by Course of French Exchange—Excess of Imports and Depreciated Currency—Grave Position of French Government Finances—Possible Recovery of the Franc—Remarks on the Other Exchanges.

ONLY recently has Foreign Exchange become a topic of general interest. Thirty years ago the foreign exchange business of the United States was in the hands of the private banking houses, which usually employed men of European birth or training to handle this branch of their affairs. To most American business men—even to most American bankers—the subject was a sealed book. It was considered an innovation when, not so very long ago, certain of the big New York banks first opened Foreign Departments. Since that time, however, the subject of the Foreign Exchanges has assumed constantly increasing importance in American banking. Greatly added impetus was given by the passage of the Federal Reserve Act, granting our National Banks the privilege, under certain conditions, of accepting time drafts drawn upon them. The National Banks were thus enabled for the first time to compete with European banks in financing the foreign trade of the United States. American banks were quick to take advantage of this opportunity for new business, and to-day most large banks maintain active and profitable Foreign Departments.

To the average business man, the subject of Foreign Exchange did not appear of much importance as long as foreign exchange rates moved within comparatively restricted limits. He was perfectly willing to let his bankers understand the

matter for him. He was sure that a pound sterling was worth about $4.86, now and forever. Minor variations didn't much matter.

It *did* matter, though, when the pound fell to $4.00, and continued to fall. The unparalleled fluctuations of exchange rates, the result of war and war's aftermath, have profoundly affected business in general. Foreign trade is of course principally involved. Many exporters have seen their whole business threatened; their best customers have been unable to pay, orders have been canceled, and it has been necessary to arrange long credits to avert disaster. Importers, on the other hand, have found themselves in possession of greatly enhanced purchasing power, an advantage limited chiefly by the restricted production of foreign shippers, who have had little to sell. The Stock Exchange quotations have likewise reflected the movements of foreign rates. And if, as seems possible, the next few month's should witness a very marked decrease in our exports, together with increased imports, the reflex on the domestic market would be incalculable. The effect on our present price levels may easily be imagined.

So important has this matter of foreign exchange rates become that upon them depends, to a large extent, the direction of trade and the course of prices. For the business man of to-day, then, an understanding of foreign exchange fundamentals has become a necessity rather than a luxury.

. . .

Foreign exchange transactions are transactions that involve the currencies of two or more countries, and the name implies the actual exchange of one currency for another. The first point to be grasped, then, is—where does the idea of the relative value of currencies come from, and on what does it depend? What is meant, for example, by saying that a pound sterling "is worth" $4.86? We state all other ideas of worth in terms of money, which we have accepted as the standard

of value. How, then, shall we define standards in terms of standards, and ascertain the value of one money in terms of another? Such comparison is possible owing to the fact that most currencies are themselves related to a single standard commodity—gold. In the gold standard countries, the unit of currency—the dollar, pound or franc—*is defined by law as so much gold, of a certain fineness.* (Frequently, as in the case of the franc and the dollar, this gold unit is only theoretical, *i.e.*, it is not itself coined, being a fractional part of the smallest gold coin minted.) To find the relative value of the currencies, then, it is only necessary to compare the quantity of fine gold contained in each. Take the dollar, containing 23.22 grains of fine gold, and the pound sterling, containing 113.0015 grains. Divide this last quantity by the first, and it appears that the pound sterling contains approximately 4.8665 times as much gold as the dollar—*or, in other words, is worth $4.8665.* This is the *par* value of the pound sterling, and in similar manner are calculated the mint pars of exchange of the other gold standard countries.

Whenever it is possible to relate the currencies of two countries back to a single commodity, a parity can be arrived at; but where the standard commodity of the two countries is different, there can be no parity. Thus a Shanghai tael has no "par value" in American money, and is worth at any time just what its contained weight of silver may be worth at the current price of silver.

Theoretically, gold is the one acceptable international money. But just as in domestic affairs settlements are made chiefly by check and very little actual money changes hands, so in foreign trade, written or wired orders of payment—drafts, checks, bills of exchange and cable transfers—are the commonest means of payment. The *supply* of these kinds of paper (collectively called "foreign exchange") originates with men who have sold goods abroad or rendered services to foreigners, thus having a claim to foreign money in payment. Such a claim will usually be embodied in a draft

(written order to pay) addressed to the buyer. The *demand* for foreign exchange springs from those who have bought goods from foreigners, or for any other reason desire to make payments abroad. In theory the exporters might sell their claims direct to the importers. In practice, however, trading in foreign exchange is centered with the so-called international banking houses—banks whose capital is sufficient to enable them to keep on deposit large balances in the financial centers of the leading foreign countries. In order to maintain their balances, these banks are always in the market to buy the drafts offered by exporters. Against the balances thus built up, the banks sell — at slightly higher rates — their own checks to the importers. It can readily be seen that such bankers' checks, backed by the world-wide reputation of the financial institutions that issue them, will possess a wider credit and will prove a more generally acceptable means of payment than any exporter's draft.

The foreign exchange rates quoted in the newspapers are not parities, but are the prices bid and asked in the current market for the various kinds of paper above mentioned.

So long—and only so long—as these orders represent a valid claim to gold, foreign exchange rates will be very close to par. It is inconvenient and expensive to ship gold, while a draft is convenience itself. The value of any draft that is backed by the assurance that gold can, if necessary, be obtained for it, is bound to approximate the value of the gold itself. Slight fluctuations in rates might be caused by the varying supply of and demand for these orders of payment. Great demand for sterling drafts might cause the rates to rise above par; but so surely as they reached a point where it became cheaper to pay the freight and insurance on gold than to buy a draft, gold would be shipped to England, until enough London credits were created to meet the demand, and rates would fall. In a similar manner, if rates fell below a certain point, foreign countries would ship gold to us, and the situation would correct itself.

The existence of such stabilizing points—the so-called gold shipping points—above and below which rates could not move, was characteristic of pre-war exchange between the United States and the financially sound countries of Europe. While these points might vary somewhat in accordance with freight and insurance rates, they remained fairly close to par. (Thus the shipping points in sterling exchange might be, say, 4.882 and 4.850.) Clearly the existence of the shipping points was solely dependent on the ability and willingness of the various countries to back up, in case of emergency, paper orders of payment by gold shipments.

Stoppage of gold shipments, resulting in the disappearance of the shipping points, may be due to various causes. Such causes would be:

(a) The physical impossibility of shipping gold.
(b) The refusal of the government to permit gold to be sent abroad.
(c) Suspension of specie payments on the paper money in circulation.

It would be impossible, for example, for a country whose ports were blockaded by a hostile navy to ship gold overseas. Should the blockaded country have pressing engagements abroad that must be met at all costs, it is apparent that the price of cable transfers in that country might rise to almost any figure. In the same manner, should the government place an embargo on gold at a time when there was a lively demand for foreign exchange, rates might be bid up without limit.

In the long run, the suspension of specie payments on fiduciary currency is of itself sufficient to affect foreign exchange rates even though there should be no great inequality of supply and demand. We have seen that the value of these orders of payment which are called foreign exchange depends on their being *bona-fide* claims to gold. If, then, the paper money of a country is made inconvertible, it means that a draft drawn on that country will be paid, not in gold of uni-

versa intrinsic value, but in paper money. Now paper money has no real value at all outside its own country, its acceptability depending on the fact that within its own country it represents a certain amount of purchasing power. Should the country in question issue great quantities of inconvertible notes, the notes would inevitably depreciate, *i.e.*, their purchasing power would decline, and foreigners would not be willing to pay so much for a draft which gave them this diminished value.

The distinguishing feature of to-day's foreign exchange situation is that—as between the United States and the former belligerent countries of Europe—one of the stabilizing shipping points has vanished. The upper limit remains; the United States stands ready and willing to ship gold to meet its obligations.[1] But the lower limit has gone. These European countries long since forbade the export of gold; they long since suspended specie payments on their notes; and all of them possess more or less depreciated inconvertible paper currency. The depreciated paper would in any case have caused a certain depression in rates on these countries. Add to this factor the perfectly unprecedented demand for dollar drafts abroad, owing to the enormous purchases made by European nations in this country—and the present situation of European exchange, quoted at from three-fourths to one-twentieth of the nominal value, is inevitable.

. . .

In order to illustrate specifically the general principles cited above, let us follow the course of the French exchanges from the outbreak of the war down to the present time. The facts may be briefly stated. On August 1, 1914, the rate of exchange for francs (par value francs 5.18 to the dollar, or 19 cents per franc) suddenly rose in New York to as high as

[1] During the spring of 1920, the United States repeatedly shipped gold to Argentina in order that the rate of exchange on that country might be maintained at reasonable figures.

4 to the dollar (25 cents) and in isolated cases even higher. For a time during August the quotation of 5 to the dollar (20 cents) was arbitrarily fixed by the leading New York banks. Rates ruled high until October, when a certain easing became noticeable, and by December of 1914 francs were at par.

There was a steady decline during the early part of 1915 until by July quotations were at 5.85 (17 cents). At about this point the French government stepped in, maintaining the rate by artificial means which will be explained shortly. From that time on to the end of the war the franc did not vary much from approximately 5.45 to 6. At the time of the armistice, there was some slight improvement, but in March, 1919, the artificial support of which we have spoken being removed, the rate fell, at first slowly, then with increasing rapidity, to recent low levels of 16 or 17 to the dollar (about 6 cents).

. . .

Such in brief is the history of the fluctuations of franc exchange. In commencing our explanation, attention should be called to the very peculiar situation which caused the astounding brief rise in exchange rates at the outbreak of the war. The United States was then, in effect, in the condition of the blockaded-nation-having-urgent-engagements that we have spoken of. War was declared, the German navy was on the seas, to ship gold was dangerous. Thus for a time the upper shipping point was gone, and in case of great demand for cable transfers, prices might rise to any height. In this case, the great demand was forthcoming. Paris bankers, who had been loaning heavily in American markets, called for instant liquidation of all obligations. In the panic bidding that ensued, rates rose to the unprecedented figures mentioned above.

On August 5, 1914, while franc rates were still extraordinary, the Bank of France suspended specie payments on its notes. Thus disappeared the other gold point. No market disturb-

ance marked this step, although it was destined to have far-reaching effects.

As the weeks passed the British navy was almost completely successful in bottling up the German fleet and sweeping the raiders from the seas. Ships could again proceed with comparative safety. In October the great fall shipments of grain were renewed, and with this movement of the crops the franc gradually fell to par.

As the war continued and it became apparent that there was to be no quick decision, the situation took a turn for the worse. Millions of men had been called to the army from agriculture and industry, and such industry as was maintained had to be largely devoted to the unproductive tasks of war. France was therefore making very few exportable goods, and was being forced to buy ever increasing amounts of supplies abroad. There was great demand for foreign exchange, with no restraining gold point, and the rate of exchange reacted to 5.85.

The stabilization of the rate near this figure was not due to any diminution in the demand for foreign drafts, or resumption of specie payments; on the contrary it was effected in the face of increasingly unfavorable trade balances and growing floods of inconvertible notes. The method was simple. Credits were opened by the British Treasury and by groups of American bankers in favor of the French Treasury, which was thus enabled—by drawing at any time upon these credits—to supply the demands of the French market for pounds sterling and dollars. Later on, when the United States entered the war, supplementary credits were granted by the American Treasury. Moreover, the vast sum required for the maintenance of the allied armies resulted in a heavy demand for francs. The Bank of France describes the procedure as follows: "During the war and especially the two last years, the advances made by the English and American treasuries, together with the expenditures of the allied armies in France, offset very largely our inadequate means of payment in foreign

countries. These extraordinary resources not only assured the ability of the state to arrange its affairs in England and the United States—they also enabled our importers to secure a supply of foreign exchange. Our sales of foreign exchange, during the periods 1917 and 1918, exceeded 11 billion: rather more than 6 billion in 1917, 5 billion in 1918. The greater part of these sales consisted of pounds sterling and dollars, which were furnished us by the treasury. Thanks to this assistance, exchange on London and New York could be stabilized at a relatively low level. At the end of 1918, the premium on the pounds sterling did not exceed 3%; that on the dollar was maintained at a little above 5%."[1]

In March, 1919, the English Treasury withdrew its support. Not long afterwards the American Treasury declined to make any further advances, and the artificial supply of foreign exchange that had been forthcoming to meet the demand abruptly ceased. The Bank of France, speaking of the year 1919, says: "For the entire year, our deliveries of foreign exchange have hardly surpassed 2,200 millions, against 5 billions in 1918. The sales during the first three months represent 1 billion 500 millions. In the other nine months we have only been able to supply our commerce with a little more than 700 millions of francs, coming from sale of securities abroad and from drawings on our 'credit with the treasury of the United States.'"

. . .

We have seen how, left to the mercies of economic law, the exchange value of the franc has fallen to about one-third of its par gold value. To say that this fall is due to great purchases abroad and depreciated money at home is probably true, but not particularly illuminating. The inquiry should go further. How far is the decline due to the unfavorable balance of trade and how far to the inconvertible money? Has it yet reached the

[1] Official report of the Bank of France for the year 1919.

bottom? Are the present conditions temporary or permanent? Questions such as these demand attention. While it would be presumptuous to attempt to give a final answer, it is hoped that a brief analysis of the present situation, financial and economic, of France, may assist the reader to draw his own conclusion.

First in regard to the great purchases abroad. During the year 1919 imports into France exceeded exports by the enormous sum of 21 billion francs. This unfavorable balance was unavoidable. French industry had not readjusted itself to the tasks of peace, and the great industrial section of the northeast was not rebuilt. Therefore there could be no great production of goods for export. On the other hand, the imperative demands of reconstruction and poor crops necessitated great imports of raw materials and foodstuffs.

It is evident that this preponderant excess of imports is essentially temporary. Already the proportion of exports to imports is growing rapidly. For the first three months of 1920 the value of exports amounted to 40% of that of imports, whereas for the year 1919 the proportion was less than 30%. Reconstruction is proceeding apace, unemployment is diminishing, and business seems generally prosperous.[1] While purchases of such articles as cotton, coal and machinery are bound to remain heavy for a year or two more, the steadily increasing sales of manufactured goods will tend to restore equilibrium.

It will perhaps be pointed out that in normal times France has always had a slightly unfavorable trade balance. In 1913, for example, and during the preceding years, exports were never more than about 80% of imports. A confirmed optimist, not unreasonably expecting that by 1925 or 1926 French trade will have returned to these "normal" figures, might go so far as to predict the substantial recovery of French exchange in five years. Such a prediction, however, would overlook the fact that in those "normal" times (when exports were but 80%

[1] For further details see Foreign Trade Report of the National Shawmut Bank for May.

of imports) French investors held Russian securities totaling some 30 billion francs (estimate of Crédit Suisse, Zurich), the returns from which were sufficient to cover a good-sized excess of imports. These investments are at present worthless, nor does there seem much chance of their early recovery. A return to normal trade position, then, will not be sufficient. The pre-war trade position will actually not be reached until France achieves a *favorable* trade balance.

Turning to the matter of the irredeemable paper money, the questions to be answered are:

(a) Have the bank notes depreciated?
(b) If so, how much?
(c) What are the chances of a speedy restoration based on the resumption of specie payments?

Disappearance from circulation of subsidiary silver coins, hoarding of all metallic currency, and excessive price rises are good evidence of a depreciation in paper money. The reports of returning travelers as to the great shortage of small change indicate that the first two conditions we have mentioned obtain in France. The question of high prices, however, is rather complicated. It is well known that, owing to general scarcity of goods, there has been a recent rise in prices of world-wide extent. A mere contrast between French prices now and in 1913 would not of itself prove that French money had depreciated. But take the case of two countries with comparatively sound currency: Canada and the United States. Prices in these countries are at present about two and a half times as high as in 1913.[1] We should naturally expect the price level in France to rule somewhat higher than this;—the war withdrew millions of men from productive tasks, and the shortage of goods would necessarily be more acute. Actually, we find that French prices are nearly five times as high as in 1913.

It is safe to say, then, that the notes of the Bank of France

[1] Estimate based on index numbers taken from the Monthly Bulletin of Statistics, No. 9, published by the Supreme Economic Council.

have considerably depreciated. Any estimate as to how much is necessarily more or less of a guess, but it is probably no exaggeration to say that the purchasing power of these notes is 30% less than that of the gold which they purport to represent.[1]

The immediate retirement of most of this note issue and the quick resumption of specie payments are not to be expected. At the beginning of the war, the note issue of the Bank of France amounted to about 7 billion francs. These notes were covered by gold and silver up to more than 70% of their face value.[2] At present the note circulation is approximately 37 billion francs. Had any appreciable part of this great increase been due to the authentic demands of business, had the liability been offset by increased commercial loans and discounts in the asset column, there would be little need to worry about the low gold reserve (14%). The unfortunate fact, however, is that 26 billion francs of these notes were issued as loans to the government. Now, compared with ordinary commercial loans, quickly liquidated and bearing a good interest rate, these advances to the state are absolutely unproductive. Twenty-one billions carry interest at 1%, the rest at ¾%; and the Bank of France is to use this interest to wipe out any losses it may eventually sustain on account of the deferred obligations it has carried since the moratorium.

Here, then, is a note issue of 37 billion francs, against which the chief items are 5 billion francs specie and 26 billions loans to the government. The imperative necessity that the government repay the bank for these advances as soon as possible is clearly evident, and in that case the bank could presumably resume specie payments on its notes. But it is extremely doubtful if such repayment will take place for a long time. The financial condition of the French government is serious, and there is no use blinking the fact.

Obviously, before repaying debts, the government must be able to balance its current budget (otherwise, even greater

[1] The Italian government has officially admitted a 50% depreciation of its notes. Import duties, if paid in paper, are twice the normal tariff.

[2] In this connection consult J. L. Laughlin's "Credit of the Nations."

note issues will be required). Now the proposed budget consists of two parts, called ordinary and extraordinary expenditures. The "ordinary" expenditures of nearly 18 billion francs will with difficulty be met by greatly increased taxation.[1] *No* attempt will be made to cover "extraordinary" expenditures of 26 billion francs, which will be charged up as *dépenses recouvrables*. Some of this may be raised by internal loans; the indemnity to be received from Germany will eventually be applied against the remainder. (How many years will it take Germany to pay such an amount? three? five? or more?) And these extraordinary expenses, in so far as they are destined for reconstruction work, are perfectly unavoidable. The Supreme Economic Council says of this matter: "It is evident that the important funds required cannot be secured from the ordinary revenue; and that on the other hand the work of reconstruction cannot await the payment by Germany of the sums due under the reparation clauses." The dilemma is indeed apparent, and it would have been obliging of the Council to have told us just how these funds *might* be raised.

The French government, in a word, faces an immediate deficit. A favorite method of raising money during the war was through the "Bons de la Défense Nationale," short-term securities maturing in three months, six months or one year. The London *Statist* has estimated (May 15) the outstanding amount of these short maturities at 46 billion francs. This floating debt must be funded, which will itself require the issue of a series of internal loans. Is it likely, then, that the government will devote much of the proceeds of such loans as may be floated during the next few years towards repaying its debt to the Bank of France—an obligation which, compared to Treasury Certificates of fixed maturity, can be so easily deferred?

In any case, great commercial prosperity is essential. Obviously the solvency of the government depends entirely on its ability to raise sufficient money by long-term loans and

[1] This compares with a budget of 5,200 million francs in 1914 (estimate of Crédit Suisse). At that time it was considered an oppressive burden.

taxes so as, first, to stabilize, eventually to diminish, the great burden of debt. And to accumulate capital, business must boom. It is not unfair to suggest that, without that commercial prosperity, some such measures as repudiation of a portion of the internal debt and partial redemption of the currency are not entirely inconceivable.

. . .

A favorable trade balance, if achieved, will undoubtedly produce a very great rise in franc quotations. During the war the rate was maintained, with no great depreciation, by foreign credits, and a renewal of such credits would undoubtedly produce a similar effect. It can be confidently asserted, however, that until French currency is reëstablished on a sound gold-paying basis the return of the franc *to par* is impossible.

No attempt will here be made to forecast how soon such reëstablishment may be hoped for. After the war of 1870, the Bank of France could not resume specie payments for 7 years, although its advances to the state were only 1 billion 500 million francs. After the Civil War, the United States did not resume such payments until 1879. The wealth of France to-day is much greater than in 1871. But she is much harder hit.

. . .

Following some such method as we have pursued, the reader may account for the present situation and in some measure forecast the future course of the other chief exchanges. Take the case of England. Nominally the trade balance has been unfavorable, imports for 1919 being valued at twice as much as exports. But enormous receipts from freight charges, insurance premiums, and banking commissions, in addition to the returns from vast investments well distributed throughout the world, leave little if any deficit. The war debt is huge, and there has been a certain inflation of the currency, with

heavy issues of Bank of England and Currency notes. But the government has already started reducing the debt, and the return of sterling exchange to the neighborhood of par within comparatively few years may be confidently expected.

In closing, it were well to reiterate—what has here been so frequently insisted upon—that the idea of value in foreign exchange ("written or cabled orders of payment") is ultimately dependent on such exchange's being redeemable in gold coin of known weight and fineness. The notion that certain European currencies are, presumably by God's immutable decree, "worth" 20 cents or 24 cents, and that the value may be at present depressed but is bound to return—is an unfortunate illusion. Governments have been known to go bankrupt before, with results disastrous to the holders of their paper currency. Here in the United States we have had our Continental Currency; some of it was eventually taken up by the states at from one-fifth to one-twentieth of a cent on the dollar, and the rest was never redeemed at all. It is an undeniable fact that certain central European governments have practically no gold reserve, an enormous debt, steadily increasing deficits, and a perfect ocean of paper money. Therefore assertions that there is no doubt but what all European currencies will eventually return to their par values should be carefully scrutinized.

THE NATIONAL SHAWMUT BANK
OF BOSTON
June, 1920

THE NATIONAL SHAWMUT BANK OF BOSTON

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